

**REPORT ON THE
FORUM ON HOUSING LOAN
RECOVERY**

BUDAPEST, HUNGARY

Prepared for

Prepared by

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REPORT ON THE FORUM ON HOUSING LOAN RECOVERY

BUDAPEST, HUNGARY

INTRODUCTION

In the last several years, Hungary has adopted a number of progressive new laws to facilitate recovery of housing loans, but there is still great uncertainty about how the laws are to be implemented. A Forum on Housing Loan Recovery was held in Budapest on October 30, 1997, to provide an opportunity to discuss issues that are addressed in new laws but not clear in practice. Participants focused on the following topics: applicability of the laws and implementing procedures, what additional changes in the laws or procedures would be beneficial, and what other actions banks can take to increase loan recovery effectiveness.

Participants included representatives of banks and their real estate sales subsidiaries, and the following agencies and organizations: the Ministry of Justice, the Supreme Court, the Association of Banks, the Hungarian Lawyers' Society, the Chamber of Executioners, and the Chamber of Notaries.

There were three formal presentations at the Forum, with the rest of the day devoted to open discussion of three pre-determined topics with designated moderators. A memorandum was prepared for the Forum participants that described the issues that would be addressed, problems relating to the issues, and some possible approaches or solutions to the problems. Copies of the agenda, the issues memorandum, and the papers prepared by the presenters are attached.

PRESENTATIONS

Carol Rabenhorst of the Urban Institute, Washington, DC, spoke on "The Legal Basis for Housing Loan Recovery in CEE: Changing to a Market-Based System." She discussed the relationship between the strength of the legal framework and control of credit risk, that is, the frequency and costs of default, and emphasized the role strong laws play in deterring default. Ms. Rabenhorst described the pre-transition legal and procedural framework in Hungary, and the significant recent improvements that have been made in the legal and procedural framework in Hungary and other countries in CEE.

Ms. Rabenhorst outlined four problems to be discussed during the Forum: (1) the high cost of public documents, (2) eviction of the debtor; (3) restrictions on the lender's ability to participate in foreclosure and priority of payment after execution, and (4) inefficiency of execution procedures.

Klaus Peter Follak of Hypo-Bank, a German mortgage bank that has opened

subsidiaries in Hungary and elsewhere in the region, gave a presentation entitled “A Western European Banker’s Perspective on Housing Loan Recovery.” After describing the basic requirements for introducing a mortgage credit system, Mr. Follak stated that the two main impediments to mortgage lending in Hungary are: (1) the lack of clear definition and satisfactory rank of the mortgage, because of the “floating charge” problem and because certain claims with priority over mortgages, such as alimony, cannot be predicted and need not be registered; and (2) the lack of efficiency and certainty in execution procedures. The lack of security of the underlying mortgages will impede the establishment of capital markets on the basis of mortgage-backed bonds. He believes the legal framework in Hungary is satisfactory, and that the system will develop and remaining problems be solved with greater experience. (As an example, he cited the former East Germany, where mortgage lending went from 4 billion DM in 1991 to 37 billion DM in 1994, after adoption of the unified German laws, and now accounts for 25 percent of the overall German volume.)

Mr. Follak made the following recommendations: (1) use of public documents for all loans, as is the practice in Germany; (2) use of the independent lien (now permitted by the Civil Code amendments), which allows a lien to be registered independent of a specific underlying claim so there can be immediate maturity and speedy execution in case of default; (3) allowing foreclosure of a floating charge only after entry in the land registry rather than just the notary registry, so that mortgages with prior registration would override a floating charge; (4) allowing notice of a foreclosure sale to serve as a writ of eviction if the property is occupied by the borrower, so that a separate eviction proceeding will not be needed if the borrower refuses to vacate.

Olga Hildenbrand of the Ministry of Justice spoke on “Highlights of Recent Changes in Hungarian Law.” She covered the 1994 Law on Court Procedure (“Execution Law”), the 1996 Civil Code amendments on mortgages, and the 1997 Law on Mortgage Banks and Mortgage Bonds, insofar as they relate to mortgage loan recovery. Ms. Hildenbrand clarified the floating charge, stating that it applied only to legal persons and therefore had no practical relevance to residential mortgage lending. She emphasized that the Law on Mortgage Banks and Mortgage Bonds changed the priority of payment after execution of any mortgage lien, placing the lender in a stronger position.

Mrs. Hildenbrand noted that many of the new provisions remain untested and it is not clear exactly how they will work in practice, but the laws are unquestionably stronger than in the past. She recommended that banks change their procedures and documents to use the new legal provisions and maximize the benefits available under the new laws.

BANK PRACTICES

Representatives of several banks discussed the procedures they use for mortgage

loan recovery.

OTP

OTP's current procedures call for written contact with a borrower who is delinquent in payment for 30 days. If the borrower then does not pay or attempt to negotiate with the bank, legal proceedings may start within 90 - 120 days. Execution procedures theoretically can begin as soon as 180 days from the start of the default, but the process can take as long as 4 - 5 years to complete. Borrowers have many tricks that can be used to delay or stop the proceedings. For that reason, OTP always tries to negotiate a resolution rather than depend on the courts to deal with defaults.

By the end of 1997, OTP expects to have new systems and procedures in effect to speed up collection of delinquent loans. Personal contact with the borrower will begin 5 days after a payment is late. This system has been used by OTP in 4 counties in Hungary for the past year, with good results. OTP also plans to institute much stricter foreclosure and eviction procedures and stricter underwriting standards. It plans to revise its standard contracts to include all security measures available under the new laws, and will begin training its staff in implementation of the new measures.

K&H Bank

K&H has been making housing loans for 1-1/2 years; to date, none of these loans has gone to foreclosure or eviction. The bank uses delinquency procedures similar to those of OTP. It has an on-line, centralized system, and sends first notice to a delinquent borrower after 10 days. A second notice is sent after 40 days. There is no experience after that.

Veresegyháza Savings Cooperative

Housing loans comprise 20 percent of the Savings Cooperative's portfolio. There are few court cases to recover loans because the bank is small and carefully assesses the creditworthiness of prospective borrowers. Direct debit from an individual borrower's account has just become possible in Hungary, and has not been used by the Savings Cooperative except for business loans. Attachment of wages is still regarded as the most efficient means of collecting bad loans, even though this procedure now requires a court order. Problems arise when the borrower cannot be located or when he has left employment to work in the "black economy." Then the bank must pursue execution, which is very slow and usually recovers only a small amount, not the full debt.

PROBLEMS IN IMPLEMENTATION OF NEW PROCEDURES

Cost of Foreclosure Based on a Public Document

■ **Discussion.** In general, lenders believe that court procedures are not an efficient means of loan recovery because of the high cost and long time required. Foreclosure is a lengthy, uncertain, and expensive process. Foreclosure based on a public document takes less time because it is not necessary to undertake a court proceeding before initiating execution, but banks do not use this procedure for residential loans because of the high notary fees for preparing public documents.

Representatives from OTP and Takarékbank stated that public documents are used for commercial loans. For such loans, sometimes the bank shares the cost with the borrower and sometimes the borrower is required to pay the whole notary fee. OTP and Takarékbank do not think that residential borrowers would be willing to pay the additional fee, or that the savings to the banks in expedited foreclosure and reduced credit risk would be sufficient to make it worthwhile for the bank to pay the fees. OTP said that some of the branches have attempted to require public documents but borrowers have regarded this as harassment because of the strong position of OTP in residential lending.

Notary fees are based on a percentage of the loan amount, and do not vary even when the bank prepares all the documents and little substantive work is required of the notary. Under the Law on Mortgage Banks and Mortgage Bonds, notary fees have been reduced by 50 percent for loan documents used by mortgage banks but not for other banks.

■ **Conclusions.** By the end of the Forum, there seemed to be greater acceptance of the idea that banks should use public documents for all mortgage loans, and there was some discussion of the idea that it might be advisable for banks to change their procedures to require this at the time the loans are made. The question of who pays or how to allocate the fees is a business decision the banks will have to make. Since ultimately the borrower must pay (either directly or in higher interest rates), this charge will affect the bank's competitive position. A number of participants agreed that foregoing the use of public documents does not result in real savings in the long run, because it impedes the bank's security and makes expeditious execution impossible.

Mr. Follak stated that there may be an issue of the legality of the provision in the Law on Mortgage Banks and Mortgage Bonds that reduces the cost of public documents by 50 percent for mortgage loans made by mortgage banks, since this may be considered discriminatory and therefore invalid under EU rules.

The representatives of the Supreme Court and the Ministry of Justice stated that the law is stronger than the lenders perceive, and it is clear that when public documents are

used and the loan agreement allows it, a bank can hold a foreclosure sale on the basis of the loan document without court action. In addition, the bank does not give up the right to seize the borrower's wages and other assets if it chooses to pursue foreclosure under a public document; it can initiate a court procedure against those other assets at the same time the non-judicial foreclosure is underway.

It was suggested that further research on this issue would be advisable, to determine the actual cost of public documents in relation to the benefit of using them, and how the costs and benefits of public documents in Hungary compare to those of other countries.

Eviction

■ **Discussion.** The new Civil Code amendments provide that if it is stipulated in the loan contract, a borrower in default must deliver the property empty of occupants. However, this provision is not self-executing and there is no indication of what happens if the borrower fails to comply.

Before 1994, when changes in the Rental Housing Law occurred, a lender had to provide alternative accommodations for evicted residents. This legal requirement has been eliminated, but in practice, banks sometimes provide another dwelling in exchange when trying to negotiate with a delinquent borrower.

■ **Conclusions.** The participants agreed that the requirement to deliver a vacant property has not been tested and it is not clear how courts will interpret it. The representative of the Supreme Court stated that a judge should issue an order of eviction without a trial if the documents are in order and a foreclosure sale is about to take place. Mr. Follak recommended that a regulation be adopted that provides that in cases where the borrower is the occupant, notice of a foreclosure sale shall operate as a writ of eviction, so that the bailiff can enforce the eviction if the borrower does not vacate by the time of the sale. (He noted that this might not be appropriate if the property is rented to a third party under a valid lease.)

The lenders agreed that it would be a good idea to make the borrower's agreement to vacate in case of foreclosure a standard part of residential loan documents.

Participation in Foreclosure (Maturity of Claim)

■ **Discussion.** The Civil Code provides that all liens and encumbrances are extinguished after a foreclosure sale, even if not all secured lenders participate in the sale. There seems to be a conflict among laws and opinions on whether a lender can participate in a foreclosure procedure if the borrower is not in default in the loan from that lender, but

another lender initiates foreclosure and sale of the property used to secure the loan.

■ **Conclusions.** It was suggested that the loan agreement could specify that if there is a default in another loan secured by the same property, the subject loan would also be due, providing a claim that would allow the lender to participate in the foreclosure. It is not clear whether the courts would agree with this interpretation. If actual delinquency is the only way to establish a mature claim, the lender's only recourse would be to attach the residual proceeds of the sale that are refunded to the borrower.

Effectiveness of Execution Officers

■ **Discussion.** According to persons who initiate foreclosure, the relevant regulations do not encourage market operations based on competition, and execution procedures are not efficient. There was discussion about whether it is advisable to modify regulations, or whether these problems will be solved when current cases in arrears, initiated before independent bailiffs were created, have been processed. It was suggested that all vacant positions for executioners should be filled, and that there should be financial incentives for effective execution (the executioner should receive a percentage of the proceeds rather than a large advance payment).

■ **Conclusions.** It was agreed that there is only anecdotal evidence available on the effectiveness of bailiffs, and it would be helpful to conduct research to determine the facts on this issue.

Floating Charge — Effect on Residential Mortgages

■ **Discussion.** The law provides for a "floating charge," which permits the attachments of all assets of a commercial borrower, including residential property, if there is a default in the commercial loan. Some people have expressed concern that a housing lender would not be protected if the borrower defaults on a separate commercial loan, especially if the commercial loan need only be registered in the movable property records maintained by the Chamber of Notaries and not in the real property records.

■ **Conclusions.** Ms. Hildenbrand explained that the floating charge can be used only to attach property that is owned by a legal person, not a natural person. Therefore, the lender's security for residential mortgage loans made to natural persons should not be jeopardized by a floating charge.

RECOMMENDATIONS FOR FURTHER ACTIVITIES TO INCREASE EFFECTIVENESS OF LOAN RECOVERY

At the conclusion of the Forum, the participants agreed that it would be beneficial to continue discussing the legal and institutional problems of loan recovery. It was suggested that smaller groups should be organized to investigate specific issues in greater detail and then report back to all the participants with recommendations for improving the legal framework, court and execution procedures, and bank practices to assure maximum loan recovery in case of default.

Improvements in Standard Residential Loan Documents and Practices

Banks should consider the use of public documents for residential loans. This will necessitate analysis of the costs incurred in relation to the benefits. If costs under the current regulatory framework cannot be justified, other means of changing the prevailing situation should be considered, such as decreasing the costs of public documents or increasing the benefits.

Banks should use loan documents that stipulate that if the borrower fails to vacate the property in case of default, no court procedure is necessary for the bank to initiate eviction. Lenders should also include a stipulation that they have a right to take part in a foreclosure of the collateral if the borrower is in default in payment of other loans.

Banks should adopt stricter loan management procedures so that action is swift and certain in cases of nonpayment.

Registration Procedures

Loan registration procedures should be revised so that a mortgage lien in the real property records cannot be compromised by a debt subsequently registered in the Chamber of Notaries registry.

Court and Execution Procedures

There is only anecdotal evidence about the length and effectiveness of court procedures. Actual loan default and eviction cases should be studied to determine if there are unreasonable delays, adjournments, duplication of procedures, or other bottlenecks and, if so, how the system can be improved.

Similarly, lenders perceive that execution officers are not as fast, efficient, and diligent as they might be. A study should be made to determine actual experience with execution procedures and practices and whether they can be improved.

Legal Framework

Several legal issues should be studied, with recommendations made if the laws and regulations should be improved. These include whether notice of foreclosure can be used in lieu of an eviction procedure if the occupant refuses to vacate and there is an appropriate provision in the loan agreement, and what is the position of the mortgage lender if there is a foreclosure of the collateral on the basis of default in another obligation.

ATTACHMENT 1

AGENDA

AGENDA

FORUM ON HOUSING LOAN RECOVERY BUDAPEST, HUNGARY OCTOBER 30, 1997

- | | |
|---------------|---|
| 8:30 - 9:00 | Registration |
| 9:00 - 9:10 | Opening remarks and welcome |
| 9:10 - 9:30 | The Transition to a Market-Based Loan Recovery System in Hungary and Central and Eastern Europe, <i>Carol S. Rabenhorst, The Urban Institute, Washington, DC</i> |
| 9:30 - 10:20 | Procedures and Practices in Housing Loan Recovery in Hungary: <i>discussion moderated by Tamás Földi, Association of Banks</i>

Current experiences on how banks handle loan recovery
Speakers (five minutes each): <ul style="list-style-type: none">— Dániel Béza - OTP— Balázs Horváth - K&H Bank— Péter Rádi - Veresegyháza Savings Cooperative
<ul style="list-style-type: none">▶ Status of the housing loan market and loan recovery practices▶ Loan renegotiation and workout▶ Experiences with execution procedures▶ The role of foreclosure and eviction |
| 10:20 - 10:40 | A Western European Banker's Perspective on Housing Loan Recovery, <i>Klaus Peter Follak, Hypo-Bank, Munich, Germany</i> |
| 10:40 - 11:00 | Coffee Break |
| 11:00 - 11:20 | Highlights of Recent Changes in Hungarian Law: Civil Code Amendments (No. XXVI/1996), Law on Court Procedure, (No. LIII/1994), Law on Mortgage Banks and Mortgage Bonds No. XXX/1997), <i>Dr. Olga Hildenbrand, Ministry of Justice</i> |

- 11:20 - 13:00 Problems in Implementing the New Laws: *discussion moderated by Éva Simó, President of Lawyers Association*
- ▶ Cost of foreclosure on the basis of a public document
 - ▶ Participating in foreclosure of other loan (maturity of claim)
 - ▶ Effectiveness of execution procedures
 - ▶ Eviction
- 13:00 - 14:30 Lunch (provided)
- 14:30 - 16:00 Developing More Effective Practices and Procedures - How Banks Can Protect Their Interests and Maximize Recovery: *discussion moderated by János Pesta, Ministry of Justice*
- ▶ Use of public documents
 - ▶ Creditors' rights in foreclosure of other loans
 - ▶ Obligation of borrower in default to vacate property
 - ▶ Formation of Working Group on loan recovery practices and procedures
- 16:00 - 16:30 Summary of key recommendations and next steps
-

Sponsor: United States Agency for International Development (USAID)
Organizers: Városkutatás Kft., Budapest
 The Urban Institute, Washington, DC
Location: Buda Penta Hotel, Budapest

ATTACHMENT 2
ISSUES MEMORANDUM

FORUM ON HOUSING LOAN RECOVERY

BUDAPEST, HUNGARY
OCTOBER 30, 1997

In the last several years, Hungary has adopted a number of progressive new laws to facilitate recovery of housing loans, but many persons remain uncertain about how the laws are to be implemented. The Forum on Housing Loan Recovery was organized to provide an opportunity to discuss relevant issues that are addressed in new laws but not clear in practice. Participants will attempt to reach a consensus on applicability of the laws and implementing procedures, what additional changes in the laws or procedures would be beneficial, and what other actions banks can take to increase loan recovery effectiveness.

DISCUSSION TOPICS

Issue 1: Cost of Foreclosure Based on a Public Document

■ **Problem.** Foreclosure has been a lengthy and expensive process. Now the law allows foreclosure without a court proceeding, but only if based on a public document, but banks rarely require a public document for housing loans because of the high cost of notary fees for preparation.

- Is it feasible for banks routinely to require a public document?
- Would borrowers be willing to pay the costs?
- Can the costs be shared by the bank and the borrower?
- Is there a way to decrease the notary fees for a public document?

■ **Problem.** Notary fees for public loan documents were reduced by 50 percent for mortgage banks but not for other banks. It is not feasible for all banks to have mortgage bank subsidiaries to make housing loans.

- What can banks do to correct this inequity?
- Can the Mortgage Banking Law be amended to change this provision?

Issue 2: Participation in Foreclosure (Maturity of Claim)

■ **Problem.** Borrowers may have loans from more than one lender. Opinions differ on whether Lender A can participate in a foreclosure procedure and recover some of the proceeds of sale of a borrower's assets initiated by Lender B if the borrower is not in default in loan payments to Lender A but is in default on payments to Lender B.

- Does Lender A have to have a mature claim to participate?

- Is actual delinquency in payment of the loan from Lender A the only way to establish a mature claim?

Issue 3: Effectiveness of Execution Officers

■ **Problem.** According to some lenders, the relevant regulations do not encourage competition among execution officers or aggressiveness in execution procedures.

- What is needed to make the execution procedures more effective?
- Is it necessary to modify regulations, or will these problems be solved when current cases in arrears, initiated before bailiffs became independent, have been processed?

Issue 4: Eviction

■ **Problem.** The new Civil Code amendments require the borrower in default to deliver the property empty of occupants. However, this provision is not self-executing, and there is no guidance on what happens if the borrower fails to comply.

- If the borrower does not vacate the house, how can the lender avoid having to initiate regular eviction procedures in court?
- Will the courts instruct the executioner to honor the right of the lender to a vacant property?

■ **Problem.** Changes in the Rental Housing Law eliminated the rule that a lender had to provide alternative accommodations for evicted borrowers. In practice, banks often still provide alternative accommodations, usually with the help of subsidiary real estate enterprises.

- Is this practice necessary or beneficial to the lender?

Issue 5: Floating Charge — Effect on Residential Mortgages

■ **Problem.** A borrower may use all his assets, including residential property, as collateral to secure a commercial loan. The commercial loan may be registered in the movable property records maintained by the Chamber of Notaries and not in the real property records.

- What protection does a housing lender have if the borrower defaults on a commercial loan secured by the same property that secures the housing loan?
- Will the housing lender be notified and allowed to participate in the foreclosure sale and proceeds?

- What is the priority of payment if there is a foreclosure?

ACTION PLAN: WHAT CAN BANKS DO TO PROTECT THEIR INTERESTS AND MAXIMIZE LOAN RECOVERY?

- Careful drafting of loan contracts
 - Eviction without court procedure
 - Rights in case of default on other loans
- Lobbying for changes in the law
- Court action to clarify law or correct inequities
- Role of Association of Banks
- Establishment of Loan Recovery Working Groups

ATTACHMENT 3
PRESENTATIONS

**THE LEGAL BASIS FOR HOUSING LOAN RECOVERY
IN CENTRAL AND EASTERN EUROPE:
CHANGING TO A MARKET-BASED SYSTEM**

Presentation by:

Carol S. Rabenhorst, Senior Legal Advisor
The Urban Institute, Washington, DC

Housing Loan Recovery Forum
Budapest, Hungary

October 30, 1997

OPENING REMARKS

Good morning, Ladies and Gentlemen.

On behalf of the United States Agency for International Development, the Urban Institute of Washington, DC, and Városkutatás of Budapest, I would like to welcome you to the Forum on Housing Loan Recovery.

This Forum is a continuation of work begun at a Colloquium on Housing Loan Recovery held in Budapest last December. The Colloquium was attended by representatives of 7 Central and Eastern European countries, 2 Western European countries, and the United States. After the Colloquium, several members of the Hungarian delegation felt that some issues identified there deserved further discussion, and this Forum is the result.

We will focus on a few specific topics that are outlined in a 2-page memorandum in your green folders. We will attempt to reach a consensus on these issues, but if consensus is not possible, at least we will all have a clearer understanding of your respective positions. We expect to have a lively discussion, and urge you all to share your thoughts and experiences.

By the end of the day, we hope to develop a plan of action that will guide future work toward solving problems in housing loan recovery.

INTRODUCTION

Even if you did not attend the Colloquium last December, most of you are familiar with various programs sponsored by USAID in the areas of housing finance and housing policy. At some point, you might have asked yourself, Why is the United States government so fascinated by housing in Hungary? The reason for this interest is the importance of the role of housing in the success of the transition to a market economy and the social and political stability of the country.

Throughout Central and Eastern Europe, homeownership is becoming a hallmark of the transition from central economies to market-based economies. Some families are building their first homes, others are improving their existing homes, or trading up to larger homes. Central governments are transferring ownership of the state or socially owned multifamily housing stock to the citizens through mass privatization programs.

The countries undergoing economic restructuring in the post-socialist era have found housing to be critically important to this difficult transition. To a large extent, the attitude of people about their overall quality of life reflect their level of satisfaction with their living conditions. Because no other sector directly affects the lives of such a large portion of the population, housing has profound political and social importance as well as economic

implications.

In both Western Europe and the United States, government agencies have played a significant role in helping more families achieve homeownership by increasing the availability of mortgage financing. They encourage and support home ownership both because it is politically popular and because it contributes significantly to the economy as a whole. Lenders aggressively pursue the residential borrowing market because it is regarded as profitable and secure.

Costs of Default

Unfortunately, not all mortgage loans are repaid. Rates of default vary significantly with the type of loan and the individual attributes of the borrower, and of course with extrinsic or macro-economic conditions.

Mortgage default is very expensive for the whole housing finance system. For lenders (and, in the United States, for institutions that guarantee and insure home mortgage loans, costs include the administrative and legal expenses of trying to collect loans in default, and the loss incurred when the net cash recovered from a foreclosure sale is less than the value of the property that is used as collateral.

A borrower who defaults also suffers losses, including a lower credit rating, legal expenses, lost work time and the emotional distress of dealing with legal proceedings, and ultimately the loss of his property.

Minimizing default loss serves the interests not only of lenders, borrowers, and government agencies, but also the many private businesses and services that depend on a vibrant, smooth functioning real estate market.

Lenders Choices

When a mortgage loan is in default, lenders have a number of choices available to them. They can simply wait to see if the borrower begins to pay again, they can attempt to negotiate with the borrower to attempt to resolve the problem, or they can initiate one or more of the legal remedies available under the law and the relevant loan documents.

Lenders choose from among these options, and decide how long to wait before acting, on the basis of business judgment. For example, if the lender determines that the borrower has a good credit record and is not paying because of a temporary illness or financial setback, the lender can decide to renegotiate the terms of the loan in a way that allows the borrower to recover and resume payments. If the lender decides that the borrower's ability or willingness to pay is not likely to change in the near future, the lender

can pursue various legal remedies, including collection from third-party guarantors, attachment of the wages of the borrower, or foreclosure and sale of the mortgaged property to recover the unpaid mortgage balance, interest, and costs.

The relative merits of these different options must be examined by evaluating the amount of time, expense, and difficulty involved in implementing each of them, and the likelihood of success each of them provides in recovering all, or at least a substantial part, of the money owed to the bank.

To make an appropriate business judgment, the lender must be familiar with the legal framework applicable to mortgage lending and debt collection, since this is a critical factor in deciding which option to pursue.

WHY IS A STRONG LEGAL FRAMEWORK NECESSARY?

Strong Laws Are a Backstop for Nonpayment

The legal framework is an essential component of the entire mortgage lending system, yet the system is predicated on the assumption that a very large percentage of borrowers will repay their loans. This apparent contradiction can be resolved if you think of the legal framework as the “backstop” or the “last resort” in the process. In an ideal world, lenders would never have to use it. But the world is not ideal, defaults do occur, and sometimes legal action must be taken.

Strong Laws Deter Nonpayment

The legal framework is important as a backstop, but perhaps it is even more important to have a strong legal framework as a deterrent to loan default. If the borrower knows he must pay or the bank will have the power to take part of his wages or even take away his home, he will do everything possible to avoid a default. On the other hand, if he knows the goal of the legal system is to protect his individual interests and to keep him in his home, even at the expense of all the other parties involved, the borrower will have little incentive to pay other than his own good intentions.

There are many positive attributes of a market-based system, but the current transition places many demands on the pocketbook of the average person, threatens employments stability, and offers many tempting ways to spend money. So even a borrower's good intentions may not be enough to keep his loan payments current. The legal system must help to assure that mortgage borrowers repay their loans so that credit will be available and affordable for many people.

Weak Laws Increase the Cost of Loans

In addition to assessing the strength of the legal framework to choose from among their options when a loan is in default, lenders look at the strength of the legal framework to evaluate their credit risk in making a mortgage loan. The risk that must be measured in “pricing” a loan is not only the likelihood of default, but also the costs of collection in the event of default. Weak laws make collection a lengthy and expensive process, even if collection efforts are ultimately successful. If the framework is weak, banks must compensate for the increased risk by increasing the cost of the loan to the borrower. If the risk is very great, the lender may be forced to charge such high rates of interest that the loans become unaffordable to most people, or may refuse to make mortgage loans at all.

Conversely, sometimes lender underestimate the strength of the legal framework, and either price loans higher than necessary (and thus discourage borrowers), or refuse to make loans that would have been sufficiently safe and profitable.

PROGRESS IN REFORMING THE LEGAL FRAMEWORK IN CEE

Pre-Transition Legal Issues

In the early 1990s, international donors conducted a number of studies of the housing finance systems in CEE as part of their efforts to assist with the transformation to a market-based economic system. They learned that the planned economies were stable from a macro-economic standpoint, and financial terms for housing loans were soft, with long repayment terms and deeply subsidized interest rates.

Lenders making residential loans did not rely only the property itself as security for the loan in case of default, but were far more likely to use remedies such as garnishment of the borrower’s wages and collection from guarantors., including garnishment of the guarantor’s wages. Because the lender was the state, and the largest employer was the state, there was essentially a closed system in which wage garnishment was quite effective in collecting from borrowers in default. In addition, in Hungary, the law afforded the state the privilege of garnishing wages without a court procedure, so the process could be accomplished easily and quickly. True mortgage financing was not necessary and rarely used.

In the early studies, there were two recurring conclusions about the suitability of the legal framework for housing finance in a market economy. The first is that the pre-transition laws allowed a borrower to use his property as collateral to secure a housing loan; in other words, mortgage lending was a legal possibility. The second is that other pre-transition laws, regulations, and firmly entrenched practices made security for mortgage loans so

weak that true mortgage lending was simply not feasible from a market standpoint.

There were several basic reasons for the conclusion that market-based mortgage lending was not feasible under the old laws. The first is that in almost all cases, foreclosure and execution of a mortgage loan involved a very long, expensive judicial procedure, or even a series of procedures. The prospect of being tied up in court for several years made foreclosure an extremely unattractive option to lenders. Second, even if the lender were willing to endure the cost and time consumption of court, and succeeded in obtaining a transfer of title to the property, meaningful access to the property so it could be sold could still remain a long way off. In order to evict the borrower, the lender had to initiate additional execution procedures (sometimes involving additional court hearings), and had to provide the evicted family with alternative housing.

Recent Changes to Minimize Credit Risk

Through a lot of careful thought and hard work, the most serious legal impediments to mortgage lending have been eliminated in most countries in the region.

The most significant changes include the following:

- The requirement for a judicial proceeding before sale of the property by the lender has been eliminated by recently enacted laws in Hungary, Slovakia, Croatia, and Poland. This is true as long as the loan documents are prepared in accordance with procedures mandated in the new laws.
- The requirement that a lender provide alternative housing when evicting a borrower after foreclosure has been eliminated in almost all circumstances.
- Steps have been taken to improve the speed and cost-effectiveness of execution procedures. Execution procedures in Slovakia, Hungary, and Croatia have been streamlined under enforcement laws adopted in the last year or so.
- Efforts are underway to improve the speed and accuracy of the titling and registration system. In general, most countries in the region have adequate, if antiquated, pre-war registration systems. The problems are more administrative than legal in nature, and will take time and a great deal of money to resolve.

Comparative Chart

This chart shows the current situation in many of the countries in CEE, and, by comparison, in Western Europe and the United States.

Summary of Current Legal Framework for Mortgage Loan Recovery in CEE Countries, Western Europe,¹ and the United States

Description	Poland	Czech	Slov.	Hung.	Croatia	WEur	US
Efficient registration procedures	No	Yes	Yes	Yes	No	Yes	Yes
Non-judicial foreclosure available	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Clear and efficient execution procedures	No	Yes	Yes	Yes	Yes	Mixed	Yes
Adequate position of mortgages in priority of liens	No	No	Yes	No	No	Yes	Yes
Ability to evict defaulting borrower	Yes	Yes	Yes	Yes	Yes	Yes	Yes
No substitute housing requirement for eviction	Yes	No	Yes	Yes	Yes	Yes	Yes

LEGAL REFORM AND ENFORCEMENT PRACTICES IN HUNGARY

Where does Hungary stand in this matrix? In recent years, several important changes have been made to strengthen the legal framework for mortgage lending in Hungary, including the following:

- Amendments to the Civil Code sections on mortgages and liens adopted in 1996 and a 1994 law on court procedures permit foreclosure and repossession without the lengthy judicial proceedings required under previous law.
- The Civil Code now permits the lender to sell the property itself without court enforcement if the parties so agreed in the loan documents.
- The Civil Code amendments provide that in the case of residential real estate, the parties may agree that the borrower must deliver the property empty of occupants in the event of foreclosure.
- The 1993 Law on Regulation of Rent and Sale of Housing exempts private landlords from the requirement of providing alternative housing to an evicted tenant.

¹ Denotes Western Europe, in the sense that most countries in the region are generally in agreement with the statement.

With this legal framework, Hungary stands at the forefront of countries in CEE in establishing the requisite legal tools for expeditious access to collateral in the event of default in a mortgage loan.

However, these significant recent developments toward a market-oriented legal framework for mortgage loans have not made a substantial difference in real estate lending practices actually used by Hungarian banks. Foreclosure and eviction still are rarely used in cases of residential loan default. Bank officials express reluctance to put families out of their homes. They believe less drastic remedies, such as renegotiating loan terms or seeking payment from guarantors, are sufficiently effective.

One reason the 1994 law on court procedures may have had little effect is that the option of expedited, nonjudicial foreclosure was available only if the loan documents were notarized, and this procedure is very expensive.

It appears that legislators and ministry officials have worked diligently to reform the legal framework for mortgage lending in Hungary, following Western European laws and models recommended by the European Commission and EBRD. But with banks not using the progressive remedies already available to them, it is unclear whether additional changes in the legal framework would in themselves increase the amount of residential mortgage lending or the efficacy of loan recovery in the near future.

REMAINING LEGAL AND PROCEDURAL BARRIERS TO LOAN RECOVERY

It is not clear why lenders remain reluctant to use the new legal procedures for foreclosure and eviction as a remedy for default, but many persons remain uncertain about how the laws are to be implemented and what effect they should have on housing loan practices and recovery procedures.

This Forum was organized to provide an opportunity to discuss relevant issues that are addressed in the new laws but not clear in practice. The issues we will discuss include the following:

- **Cost of Foreclosure Based on a Public Document.** The Law on Court Procedures allows foreclosure without a judicial procedure if the loan documents are prepared by a public notary. Lenders report that notarization is too expensive and does not make the process faster. Is this procedure effective, or there anything that can be done to make it more effective?
- **Participation in Foreclosure (Maturity of Claim).** Borrowers may have loans

from more than one lender. Opinions differ on whether Lender A can participate in a foreclosure procedure and recover some of the proceeds of sale of a borrower's assets initiated by Lender B if the borrower is not in default in loan payments to Lender A.

- **Effectiveness of Execution Procedures.** While laws have been changed to expedite foreclosure procedures, lenders report that execution is still a very lengthy process. Is there anything else that can be changed in the legal framework to make execution faster?
- **Eviction of the Resident/Borrower.** The new Civil Code amendments require the borrower in default to vacate the property if the lender forecloses, but this provision is not self-executing and there is no indication of what happens if the borrower refuses to comply. Does the lender have to initiate regular eviction procedures in court, or is there a more expeditious solution to this problem?
- **The "Floating Charge."** A borrower may use all his assets, including residential property, as collateral to secure a commercial loan. The commercial loan may be registered in the movable property records maintained by the Chamber of Notaries and not in the real property records. What protection does the housing lender have if the borrower defaults on a commercial loan secured by the same property that secures the housing loan? What is the priority of payment if there is a foreclosure?

We will begin with a discussion of practices and procedures used by various housing lenders.

LOAN RECOVERY FORUM, BUDAPEST, OCTOBER 1997
A BANKER'S VIEW

Dr. Klaus Peter Follak, Munich

ECONOMIC BACKGROUND

The key role of the finance industry to investment in housing and real estate, growth, high levels of employment and monetary stability has been underscored by the EU White Paper "Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union" (May 1995). Following the White Paper, legislative focus should be on areas, where the greatest effect can be expected. Therefore, it is recommended to introduce mortgage finance and bank lending against real estate collateral during the first stage of the legal adaptation.

"One very important activity, and especially in economies transforming themselves into market economies, is mortgage credit. A correctly functioning mortgage credit sector cannot exist without a legal infrastructure, such as clear rules for ownership of real estate, transparency concerning old claims (e.g., taxes) on the property and a correctly functioning land register, where mortgages can be registered and legal provisions to enforce the mortgages, development of a valuation profession could also be recommended."

However, the White Paper does not recommend a specific legal system. Following the principle of minimum harmonization, private law and execution law will remain within the competence of national discretion.

In the meantime, the reform of the Hungarian legal system has been set in motion. Therefore, the Hungarian legal system benefits from a good stock of laws which might require some appropriate amendment and improvement but not a fundamental reshuffle.

BASIC REQUIREMENTS

What are the basic requirements related to the introduction of mortgage credit and lending against real estate collateral?

- Clear establishment of property rights and clear titles.
- Efficient establishment of bank security rights.
- Speedy execution of property-related transactions at feasible costs.
- Clear planning law and planning consents as a reliable basis for the value of the collateral.
- Liberal law of landlord and tenant, as a basis for the rental value of the property.
- Additionally, regulation of professional valuations would be helpful.
- Further legal requirements would be clear and sound regulation of mortgage banking and mortgage-backed securities.
- Economically, monetary stability to a reasonable extent and the development of open real estate markets will be necessary.

PROGRESS ACHIEVED AND REMAINING PROBLEMS

MORTGAGE BANKING

Mortgage banking and the issue of mortgage backed securities have been regulated satisfactorily by the Hungarian Mortgage Bank Act.

CLEAR ESTABLISHMENT OF PROPERTY RIGHTS AND CLEAR TITLES

The principle of the constitutive effect and public faith of the entry into the land register, along with preliminary titles prior to the final entry into the land register already form a solid basis for straightforward transactions.

Certain problems can be identified in the system of the land register. In East Germany, the update of the land register had proved to be a major obstacle for at least 2 years. Although the introduction of related EDP systems is underway in Hungary, several local registries seem to have problems in providing the quality required. These problems might be connected with the transfer of the responsibilities from the courts system to the local governments in the sixties. According to Article 28 of the Mortgage Bank Act, land registrars have to handle applications for mortgage registration by mortgage banks with priority. This rule seems to discriminate other lenders as well as foreign banking institutions benefiting from a license for an equal range of business fields and hence might not be in accordance with EU law.

EFFICIENT ESTABLISHMENT OF BANK SECURITY RIGHTS

Insufficient enforcement of bank collateral is broadly related with risks concerning the safety and soundness of banks. This problem is particularly severe as long as these institutions have not yet built up sufficient reserves. Clear security titles and enforcement procedures would be a pre-condition for the establishment of capital markets on the basis of mortgage-backed securities, because related risks would affect the safety and soundness of such bonds.

With regard to the mortgage, two fields of problems exist in every reform country:

- Clear definition and rank of the charge;
- Execution of the charge.

RANKING PROBLEMS

Overriding Claims

For many years, claims of alimony and for maintenance, claims of work contracts, fiscal claims and social security claims had priority in Hungary. The problem is that neither the existence nor the amount of these overriding claims can be recognized in the land register. Therefore, the actual value of a charge would not be foreseeable from the creditor's point of view. The introduction of 29 Mortgage Bank Act has improved the situation significantly. Regarding the distribution of the proceeds in a public auction, only the costs of the execution, claims of alimony and employees' wages would override a mortgage. However, the solution seems not yet perfect. Maintenance claims resulting from divorces are one of the main reasons for arrears of private individuals, and just in this case a first mortgage would not help.

Overriding claims of work contracts have proved to be a serious obstacle to the development of regular commercial property finance in France. In practice, the ownership of commercial properties could be transferred to a single-purpose company not acting as an employer. In this case, related risks could be minimized.

Inter-Relationship Between Mortgage and Floating Charge

The floating charge over property including real estate (254 CC) can be established by the entry into a register maintained by the National Chamber of Notaries. With regard to property rights, this seems to contradict the constitutive effect and the public faith of the entry into the land register. The problem can be solved if the floating charge is interpreted as a remainder in the sense of a future interest which would crystallize upon opening the right for satisfaction (254 ii CC) by the entry into the land register. In this case, mortgages with a prior entry would override the floating charge.

EXECUTION

Markets for Property Subject to Forced Sale

Basically, all reform countries suffer from a lack of experience with regard to execution. Therefore, the adaptation and completion of the related legal basis would be a pre-condition for the development of specific real estate markets which could take up properties subject to forced sale. In practice, obstacles to the take up of auctioned real estate seem to be connected mainly with residential property, whereas foreclosures have been performed successfully for commercial properties. The negative publicity caused by the eviction of families seems to be regarded as a problem by banks and purchasers. In

the long run, only alternative accommodation by public housing might help.

Sequestration

As in most reform countries, liens on property can be realized by forced sale but not by sequestration. This means that only the market value of the property itself is subject to execution but the current income out of the property as a separate economic value, in particular rental payments. Sequestration, by contrast, would be a more lenient way of execution, because in this case only the current income of the property would be seized. Therefore, the introduction of sequestration is strongly recommended. A solution might follow the context of 253 CC, but an amendment of the EL would have to provide regulation for the distribution of the income earned.

Public Documents

Basically, an enforced judgement on payment would be a condition of entering execution procedures. However, a writ of execution on the basis of a contractual title, established by a notary, is possible. In Germany, the writ of execution is regular practice with both corporate customers and private individuals.

Free Sale

The regular way of execution of mortgages is forced sale by public auction, carried out by a court. However, 264 CC allows private auctions or free sale by professional creditors such as banks if both parties have agreed on this opportunity. An additional advantage is that minimum prices may be agreed by the parties and would not be restricted to 50 percent of the estimated value (see 147 ii EL). One might argue that 264 CC can replace only the procedure of a public auction but not the enforced judgement on payment. Therefore, a writ of execution (public document) should be established in any case.

Execution by free sale does not seem to be regular practice. What are the reasons?

- Liability risks from the point of view of the bank, e.g., responsibilities for prices achieved.
- The legal basis for the change of ownership seems somewhat unclear. What would be the requirements of the land registrar?
- Only the mortgage in question would be involved, i.e., other liens and encumbrances remain. Who would buy a property which is still seriously encumbered?
- The instrument of free sale can only be successful if it is carried out by experienced institutions. Banks would suffer from lack of experience and hence might set up special companies with a licence for sale, private auction,

liquidation and bankruptcy procedures.

Independent Liens (269 CC)

In Germany, the independent lien as a mortgage on its own right has proved to be an excellent instrument, because it is independent from a specific underlying claim and hence can serve as a collateral for, a variety of claims with fluctuating amounts. It is used regularly in connection with a separate bill of debt or debenture and a writ of execution. As the bill of debt is established with immediate maturity, it enables speedy execution. The problem is that in Hungary neither specific legislation nor case law regulating the procedure exists.

Estimated Value and Minimum Bid

Realistic pricing would be a pro-condition for the marketability of property subject to forced sale. According to 140 EL, the value is determined by the bailiff, taking the official tax and value certificate into account. These certificates quite frequently follow principles far away from open-market considerations. Valuations should be based on realistic assumptions, and the related regulation based on 5 Mortgage Bank Act should be integrated.

In case of repeated auctions, a bid below 50 percent of the officially estimated market value should be admissible.

Eviction

According to 48 CC, the parties shall agree that the property has to be delivered in a vacated state. However, in most legal systems rent contracts are normally not affected by the execution of a mortgage. The value of rented property depends on the rental value and hence on the rent contract.

It is assumed that the agreement mentioned above cannot serve as a title for the execution. However, it is recommended that the document on the auction sale should serve as a writ of execution against an owner-occupant. This opportunity would have to be introduced as an amendment to the EL.

Participation

Following 137 EL, liens and encumbrances will not remain after the auction. This rule only makes sense in case all liens and encumbrances which can be realized in terms of money would be settled in the course of the distribution of the proceeds which should be clarified by law. In any case banks should include clauses in their loan contracts providing for early maturity in case of sequestration. Additionally, a writ of execution seems advisable.

LAW OF LANDLORD AND TENANT

Open market financing of residential property basically requires a market-oriented rental system which might be introduced step by step because the value of rented property depends on the rent contract. The marketability of rented property subject to forced sale would be improved if the landlord could terminate the contract by establishing his need of the property as the sole residence of himself or a family member.

FINANCING CONDOMINIUMS

Refurbishment

Financing the refurbishment of condominiums might be difficult as far as parts in collective ownership are concerned. These parts such as the roof, walls, etc., do not represent a separate property as an economic value and hence cannot be mortgaged independently from the individual condominiums. This situation would not change even in case the collective of the owners was established as a legal person, because the collateral would still be owned by separate individual persons. Therefore, each holder of a condominium would have to establish a mortgage on his property. In practice, the easiest way would be a cash payment to the collective by each holder, who would be responsible for the financing of his share by himself.

Construction

Regarding construction finance, two legal issues can be recommended:

- Banks financing cooperatives or construction companies should be obliged to release related collateral supplied by the purchaser of a condominium, as soon as the construction has been completed and the purchaser has paid the full price of his specific unit.
- A legal schedule with maximum amounts of prepayments by the purchaser of a condominium should be issued, following the progress of the construction.

OUTLOOK

Basically, the legal system of real estate security in Hungary benefits from a good stock of laws. Once the remaining problems have been tackled, a speedy development of property finance can be expected. In East Germany, for example, only DM 4bn mortgage

loans were committed in 1991. Following the legal adaptation, the mortgage industry developed quickly. In 1994, the German mortgage banks committed 36.8bn in East Germany, 25 percent of their overall volume. Commitments for multi-family houses increased by 75 percent.